

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

77-5004

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P/S

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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HOUSEHOLD FINANCE CORPORATION,

Plaintiff-Appellant,

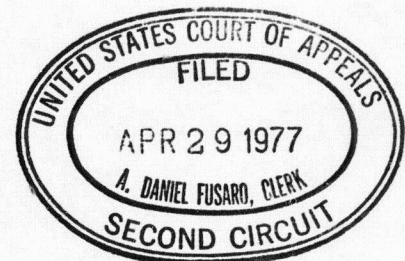
-against-

KEITH ORIN DANNS a/k/a KEITH O. DANNS
a/k/a KEITH DANNS,

Defendant-Appellee.
-----x

ON APPEAL FROM THE UNITED STATES
DISTRICT COURT FOR THE EASTERN
DISTRICT OF NEW YORK

BRIEF FOR DEFENDANT-APPELLEE



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a/k/a KEITH DANNS,

Defendant-Appellee.
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BRIEF FOR DEFENDANT - APPELLEE

QUESTION PRESENTED

Where a creditor advances additional money to a debtor in reliance on a fraudulent financial statement, is the denial of discharge under Section 17 (a) (2) of the Bankruptcy Act properly limited to the "fresh cash" advanced in connection with the statement, and is the preexisting debt, not tainted by the fraud, dischargeable?

STATEMENT OF THE CASE

1. Introductory

Household Finance Corporation (HFC) appeals from

an order of Hon. Edward R. Neaher, United States District Judge for the Eastern District of New York, dated January 17, 1977, which affirmed an order of Bankruptcy Judge C. Albert Parente, dated July 2, 1976. Judge Parente ordered that the application of HFC, pursuant to Section 17 of the Bankruptcy Act, to declare the debt due it in the amount of \$2,189.31 by Keith Orin Danns as non-dischargeable be denied, except to the extent of the "fresh cash" in the amount of \$483.00.

2. Statement of Facts

On January 24, 1975 Danns, already in debt to HFC in the amount of \$2,019.37, obtained a loan for additional monies which increased his total obligation to HFC to the amount of \$3,261.96. After subtracting the amount of the existing loan and finance and other charges, Danns received \$483.00 additional money from HFC.

The Bankruptcy Judge found that the financial statement submitted to HFC by Danns to obtain this loan was false and awarded to HFC the amount received by Danns as a result of the false financial statement, that is, \$483.00, but permitted the discharge in bankruptcy of the outstanding balance of the prior loan. The decision of the Bankruptcy Judge was

affirmed on appeal to the District Court.

ARGUMENT

POINT I

SECTION 17 (a) (2) OF THE BANKRUPTCY ACT, IN SPECIFYING EXCEPTIONS TO DISCHARGE, IS TO BE STRICTLY CONSTRUED IN FAVOR OF THE BANKRUPT.

"[T]he basic purpose of the Bankruptcy Act [is] to give the debtor a 'new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt' " Lines v. Frederick, 400 U.S. 18, 19, 91 S. Ct. 113, 114, 27 L.Ed. 2d 124, 127 (1970).

In accordance with this basic purpose exceptions to discharge should be construed, so far as reasonable, in favor of the bankrupt. Gleason v. Thaw, 236 U.S. 558, 35 S. Ct. 28, 59 L.Ed. 717 (1915).

1. The Situation Prior to 1960

Prior to 1960, a lender who advanced money based on a false financial statement had two avenues of redress. The lender could proceed under Section 14 (c)(3) and bar discharge in bankruptcy entirely, or could proceed under Section 17 (a)(2) and bar discharge of the debt owed them-

selves. Where proceedings under Section 17 (a) (2) resulted in the "fresh cash" issue being faced, a slight majority of state courts decided in favor of barring discharge of the entire loan and not the "fresh cash" alone.

In 1960 amendments were made to these two sections for the purpose of limiting "the use of financial statements as a bar to discharge in bankruptcy". S. Rep. No. 1688 (2 U.S.Code Cong. & Ad. News, 86th Cong. 1st Sess. (1960) p. 2954). H.R. Rep. No. 1111, which is quoted in S. Rep. No. 1688 at p.2955, sets out the abuses which these amendments were intended to rectify:

The committee believes that complete denial of a discharge is too severe a penalty in the case of the individual noncommercial bankrupt. It is also a penalty which experience has shown to be subject to abuse. An unscrupulous lender armed with a false financial statement has a powerful weapon with which to intimidate a debtor into entering into an agreement in which the creditor agrees not to oppose the discharge in return for the debtor's agreement to pay the debt in full after discharge. The creditor may also accomplish his purpose of preserving his debt by not opposing the discharge and then suing in a State court on the ground that the debt is not dischargeable. Testimony before the Subcommittee on Bankruptcy and Reorganization by experts in bankruptcy law indicates that unscrupulous lenders have frequently condoned, or even encouraged, the issuance of statements omitting debts with the deliberate intention of obtaining a false

agreement for use in the event that the borrower subsequently goes into bankruptcy.

Even where the creditor has had no part in the issuance of a false financial statement, the exercise of his right to bar the discharge completely results in a windfall for other creditors who were not even aware of such a statement. Debts which are dischargeable are not discharged solely because one of many debts was induced by a false financial statement. This result is not required to protect a creditor who has relied on a false financial statement since under section 17a(2) that particular debt is not dischargeable.

In view of the protection which section 17a(2) gives to the creditor, and in view of the abuses which have grown out of section 14c(3), the committee believes that it is desirable to eliminate the false financial statement as a ground for the complete denial of a discharge insofar as the individual noncommercial bankrupt is concerned.

As a result of these changes in the law Section 14 (c) (3) could no longer be used as a total bar to bankruptcy in consumer cases. Furthermore, certain language was added to Section 17 (a) (2). The text is as follows with the new matter added in 1960 underlined:

"(a) A discharge in bankruptcy shall release a bankrupt from all his provable debts, whether allowable in full or in part, except such as ... (2) are liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension

or renewal of credit in reliance upon
a materially false statement in writing
respecting his financial condition made
or published or caused to be made or
published in any manner whatsoever with
intent to deceive."

The new language is taken in substance from Section
14 (c) (3).

2. From 1960 to 1970

Those state courts that met the "fresh cash"
issue in the period from 1960 to 1970 felt that the addi-
tional language was meant as a bargain whereby in exchange
for giving up the right to bar the discharge in bankruptcy
of debtors obtaining loans fraudulently, lenders were now
unequivocally estopped to bar the discharge of not only
the "fresh cash" actually received as a result of a fraud-
ulent statement, but the entire loan.

This interpretation of the additional language
in Section 17 (a) (2) has been termed a "colossal error".
Lee, Leading Case Commentary, 46 Am. Bankr. L.J. 245, 248
(1972).

Judge Lee concluded that "[t]he real intent was to
preserve the validity of existing case law upon repeal of
Section 14 (c) (3) of the Act in its entirety as contemplated
by the original version of The Celler Amendment." *Id.* at
251.

To substantiate his position Judge Lee quotes the testimony of Mr. Linn K. Twinem, at the Hearings on H.R.106 Before a Subcommittee of The Senate Committee on The Judiciary, 85th Cong., 2d. Sess. pp. 49-50. Mr. Twinem, then attorney for Beneficial Finance Company and the Chairman of the American Bar Association bankruptcy committee on current decisions testified as to the point in question, as follows:

MR. TWINEM. Yes, sir. Before getting to the controversial section there was some discussion about the reason and purpose of section 4 [Section 17(a)(2)] and why we had this language in here that has been inserted, in lines 14 to 19.

From my discussions with Mr. Covey and others who have had some interest in this bill, and some of whom have participated in the drafting of the bill, this language, with a slight variation was lifted from the old section 14 and the reason is because there have been many interpretations of this particular language in the cases that have been handed down since 1898, and by putting it over here, we will still have the value of the interpretation of those cases, if that is important.

From my standpoint, I see no particular reason for having section 4 at all.

But I am merely trying to explain why this language in lines 14 to 19 was lifted out of 14 and brought over here.

I think that is the reason but I do not know whether it is a sufficient justification.

So that there can be no question as to the significance of this testimony Judge Lee explains as follows:

Since the federal courts in interpreting old Section 14c(3) of the Act had dealt only with the question of whether the bankrupt should be denied a discharge as to all debts, and thus had not been called upon to decide whether publication of a false financial statement precluded discharge of the entire amount of a particular debt or only the fresh cash advanced in reliance thereon, it can hardly be said that the Celler Amendment is evidence of congressional intent to adopt the so-called majority rule as to the nondischargeability of the full debt.

Lee, supra at 251.

3. The Situation Since 1970

In 1970 subsection (c) was added to Section 17 which gave exclusive jurisdiction to the Bankruptcy Courts over Section (17)(a)(2) dischargeability questions. Since 1970 in the vast majority of the federal cases that have considered the "fresh cash" issue it has been decided that only the "fresh cash" realized as a result of the fraudulent statement should be barred from discharge in bankruptcy and not the entire loan. Townsend, "Fresh Cash" - Another Element Of A Bankrupt's "Fresh Start"? 31 U. Miami L. Rev. 275, 281-286 (1977).

As to congressional intent Judge Weinstein said in Manufacturers Hanover Trust Company v. Stanzione, 74 B 138 (E.D.N.Y. 1974), referring to H.R. Rep. No. 1111, that "[n]othing was said regarding the 'extension or renewal' language. The language of the present Section 17 (a) (2) is almost exactly that of the former Section 14 (c) (3) which suggests that the draftsmen of the 1960 Amendments simply transferred the language of Section 14 (c) (3) to Section 17 (a) (2) without considering the issue now posed."

Judge Weinstein further said: *

The scarcity of comment in the House Report on the section 17 (a) (2) amendments may be attributed to the fact that Congress was primarily interested in eliminating the section 14(c) bar to discharge for noncommercial debtors. While Congress did recognize that dishonesty and fraud would not warrant discharge of a debt, it appears to have intended that, for the noncommercial debtor, the types of nondischargeable liabilities be as specific and as narrowly defined as possible. The addition of the elements of reliance and intent to deceive to section 17(a) (2) is consistent with that intent.

In In Re Schuerman, 367 F. Supp. 1347, 1349 (E.D. Ky 1973) the problem was addressed as follows:

The 1960 amendment as originally drafted repealed Section 14(c) (3) in toto and vested authority in the Bankruptcy Courts to determine the dischargeability of debts under Section 17(a) (2); as enacted, Section 14(c) (3) was retained but limited to business bankrupts, and state courts continued to en-

ertain actions by injured creditors. Thus, the legislative transfer of similar language from one section to another was intended only to preserve existing rules modifying the provision as a whole and should not be interpreted as embracing state decisional law on this particular point. The Celler Amendment did not evince an intent to adopt the majority state rule since it had not previously been necessary for federal courts to consider the question.

Therefore, the principle, that exceptions to discharge must be strictly construed in favor of the bankrupt, must prevail and this principle points directly to the validity of the decisions of the Bankruptcy and District Court judges.

POINT II

DANNS NEITHER OBTAINED CREDIT NOR
AN EXTENSION OR RENEWAL OF CREDIT,
WITHIN THE MEANING OF SECTION 17
(a) (2), AS TO THE PREEXISTING DEBT.

1. Extension or Renewal of Credit

Judge Neaher stated that "... HFC did not show that Danns was delinquent in his payments on the prior loan and received an 'extension' of time to pay it off or that he had been granted a renewal of a matured note". (Appendix 83) he added that "[t]he result might have been different had the record shown a true 'extension' or 'renewal' of credit in reliance upon the financial statement"

(Appendix 83)

In Stanzione, supra, Judge Weinstein stated that "... limiting the liability only to new cash would not void the effect of the 'extension or renewal' language. The record does not show that this was a case of a debtor being delinquent in his payments and receiving an 'extension' of time to pay off a prior loan Nor was this a 'renewal' of a matured note. Thus, the fraud caused no loss to the bank except that resulting from its disbursement of the fresh cash."

2. Obtained Credit

In a related question, Judge Neaher stated that because "... New York Banking Law Section 352 requires the consolidation of loans from one creditor, 'it is difficult to characterize the refinancing as being 'obtained' by the debtor within the meaning of Section 17(a)(2)'" (Appendix 83) Again, Judge Neaher, states that "[t]he result might have been different had the record shown ... that Danms requested the consolidation of the loans because he would thereby benefit." (Appendix 83-84)

In Beneficial Finance Company v. Ellis, 400 F. Supp. 1112, 1116 (S.D. N.Y. 1975) Judge Carter dealt with this issue at greater length:

(1) that Beneficial did not rely on the false financial statement in refinancing the prior loan, and hence the refinancing was not "obtained" by the statement, since there was no evidence that the bankrupt's prior note was in default, due, or that the bankrupt had ever submitted a materially false statement relative to the prior loan; (2) that the refinancing was not "obtained" at the behest of the bankrupt, but instead was coerced by Banking Law 352 (McKinney's 1971); (3) that the refinancing was for the convenience of Beneficial, and consequently not "obtained" by the bankrupt; and (4) that there was no intent to deceive Beneficial as to the refinanced portion of the loan, since the refinancing was forced upon and not obtained by the bankrupt who, without funds to pay the original loan balance, was presented with no alternative.

In The Matter of Reynolds, 71 B 932 (S.D.N.Y.1972)

substantiates this position:

The renewal of the existing loan in connection with the extension of new credit, i.e., "fresh cash", is coerced by statutory regulations affecting the lender applicant so that, on the facts of this case, it cannot be said that the extension or renewal of credit was "obtained" by or granted at the request of the bankrupt within the meaning of Section 17a(2) of the Act, but rather it was granted for the convenience of the lender to avoid its violation of restrictions on interest charges. In New York, Section 352 of the Banking Law (Small Loan Act), forbids a licensed loan company from permitting

a borrower "to become obligated ... under more than one contract or loan at the same time", without restricting its chargeable interest rate. Consolidation of so-called "split loans" was mandated to avoid compounding of interest prohibited by the Act.

POINT III

THE PROPER MEASURE OF DAMAGES TO THE LENDER IS THE ACTUAL PECUNIARY LOSS STEMMING FROM THE FRAUD.

The Bankruptcy Judge found that Danms had committed a fraud on HFC and through this fraud had realized \$483.00. This amount was awarded to HFC by the Bankruptcy Judge. This decision is well founded "on the theory that the false financial statement exception of Section 17 (a) (2) sounds in tort" and "that the measure of damages to be applied is the state law rule in fraud cases, that is the 'actual pecuniary loss' flowing from the fraud". In Re Fuhrman, 385 F. Supp. 1185, 1186 (W.D.N.Y. 1973)

Furthermore, "it would be illogical to except from discharge that portion of the pre-existing debt which is untainted by fraud". In Re Soika, 365 F. Supp. 555, 556 (W.D. N.Y. 1973) Any other result would penalize the debtor far beyond his gain from the fraud.

This position in no way aids the dishonest debtor but merely assesses a penalty that is both consistent with the law and equal to the wrong.

The contention that Section 17(a)(2) gives an action in contract to the creditor and that therefore the damages assessed must be in accordance with a contract rule of damages, must be answered within the context of the 1970 amendment to the Bankruptcy Act.

H.R. Rep. No.91-1502 (1970 U.S.Code Cong.& Ad. News, p.4156) states that under the law prior to 1970:

... creditors are permitted to bring suit in State courts after a discharge in bankruptcy has been granted and many do so in the hope the debtor will not appear in that action, relying to his detriment upon the discharge. Often the debtor in fact does not appear because of such misplaced reliance, or an inability to retain an attorney due to lack of funds, or because he was not properly served. As a result a default judgment is taken against him and his wages or property may again be subjected to garnishment or levy. All this results because the discharge is an affirmative defense which, if not pleaded, is waived.

If the affirmative defense was pleaded then the creditor answered by alleging facts that constituted a bar to discharge of the debt under Section 17(a)(2).

The creditor did sue on a contract, that is, the

promissory note.

Since the addition of 17 (c) the action is brought in the Bankruptcy Court and is, in effect, a request by the creditor that its contract not be abrogated in Bankruptcy but be reinstated because it falls within the exception to discharge listed in Section 17 (a)(2). It has been fully developed above that there being no Congressional intent evinced to the contrary, Section 17 (a)(2) in specifying exceptions to discharge, is to be strictly construed in favor of the bankrupt. This rule of construction can best be effectuated by applying the "actual pecuniary loss" measure of damages applicable in fraud cases. This in no way denies that the cause of action is statutory, but does rule out a contract measure of damages.

Brief for Appellant, p.24, states that if HFC had known of the falsity of Danns' statement at the time it was made, HFC would never have granted the new loan but would have immediately accelerated the old one if Danns defaulted for any period. It is concluded from this that equity requires barring discharge of the entire debt and not merely the "fresh cash".

In fact equity requires that the parties be restored to the position existing at the time of the wrong.

Assuming, arguendo, that HFC learned of the fraud and would have refused the loan, HFC would still have its \$483.00 and the original loan, untainted by fraud, would be discharged in bankruptcy without the least question. This is exactly how both the Bankruptcy Judge and the District Court Judge have decided this case.

CONCLUSION

The basic purpose of the Bankruptcy Act is to give the debtor a fresh start free of debt. In furtherance of this purpose exceptions to discharge should be, so far as reasonable, construed in favor of the Bankrupt.

Danns neither obtained credit nor an extension or renewal of credit, with the meaning of Section 17(a)(2), as to the preexisting debt.

The proper measure of damages to the lender is the actual pecuniary loss stemming from the fraud of the debtor.

Defendant therefore respectfully urges the court to affirm the decision of the District Court.

Respectfully submitted,

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